A Quarterly Newsletter for Clients of Parsons Capital Management

Perspectives

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PARSONS
Capital Management, Inc.

Corporate Headquarters
10 Weybosset Street
Suite 1000
Providence, RI 02903-2808
Phone 401.521.2440
Fax 401.521.4870
Toll-Free 888.521.2440

Florida Office
11450 SE Dixie Highway
Suite 205
Hobe Sound, FL 33455
Phone 561.868.2440

QUARTER 4, 2016

by John Mullen and Ruth Mullen

It paid to stay home in the fourth quarter as US markets, buoyed by improving economic indicators and a surprise win for Donald Trump, handily outperformed the rest of the world. Domestically, the risk-on trade was in full force amid expectations that the Republican sweep would mean lower taxes, lighter regulation and increased spending - ushering in faster economic growth. Reflecting this new confidence, value stocks greatly outperformed their growth peers. While the Trump victory helped to spur the US markets higher, it took a toll on international markets as uncertainty over the future of trade policies weighed on the economic outlook for countries across the globe. Emerging markets were especially hard hit.

Data as of December 31, 2016	Dec. '16	Qtr. 4 '16	YTD '16
S&P 500	1.98%	3.82%	11.96%
MSCI AC World Index (incl. US)	2.20%	1.30%	8.48%
MSCI EAFE (Europe, Asia, Far East)	3.34%	-0.68%	1.51%
MSCI EM (Emerging Markets)	0.29%	-4.08%	11.60%
Russell Largecap	1.88%	3.83%	12.05%
Russell Largecap Growth	1.24%	1.01%	7.08%
Russell Largecap Value	2.50%	6.68%	17.34%
Russell Midcap	1.14%	3.21%	13.80%
Russell Smallcap	2.80%	8.83%	21.31%

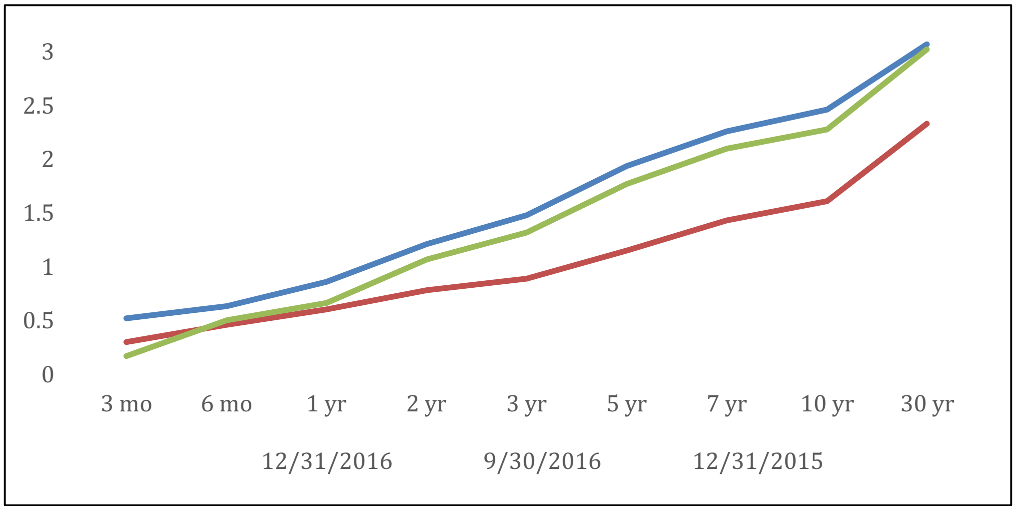
FIXED INCOME MARKETS

The fixed income market posted one of its poorest quarterly performances in years during the fourth quarter. Similar to the stock market, international bonds fared worse overall with the Barclays Global Aggregate falling -7.07% in the quarter compared to a decline of -2.98% for the US Aggregate. US Treasuries saw the biggest declines, as investors sold in favor of more risky investments. In fact, high yield bonds were the only class of fixed income to post a positive return in the quarter to finish the year with a total return of +17%. Municipal bonds were also hard hit in the fourth quarter due to uncertainty over their future tax treatment under proposed tax reform.

US TREASURY YIELDS

Yields across the treasury curve rose when compared to both a year ago and the end of the third quarter. The short end of the curve rose as the Fed chose to raise rates at their December meeting and outlined an initial plan for three rate increases for 2017. Longer dated yields saw an even more significant move with much of the change occurring in the weeks after the election. The increase in the long end of the curve was driven by the dual forces of better than expected current economic data and an optimism that a Republican controlled government will enact pro-growth policies.

Fed pushing up short rates while higher growth & inflation moving the long end…



COMMODITIES

The price gains for commodities in the fourth quarter were widespread, with gold being one of the few to post a decline. The improved growth outlook that began to take hold after the election sent gold prices into a tailspin, falling -11.7% in value from November 4th to the end of the year. The expectation for better economic momentum going forward that led to a rise in bond yields also pushed the US dollar higher by 7%. Both factors made gold less of a store of value.

Gold loses its luster…

The brighter economic picture that worked to the detriment of gold was a boon for much of the other commodity complex. Oil prices shrugged off the rise in the dollar as confidence grew in the outlook for global demand and OPEC followed through on their September agreement with the announcement of specific production cuts following two years of unfettered pumping. Strength in oil prices bled through to the gasoline and natural gas markets, up 14% and 28% respectively.

OPEC finally delivers…

Perhaps no commodity proved to be a better barometer of the improved global growth expectations than copper. Nicknamed "Dr. Copper" for its ability to quickly gauge the vigor of the global economy, the industrial metal posted a 13% gain in the quarter.

Dr. Copper giving clean bill of health…

Commodity	Qtr. 4 '16	Year to Date '16
CRB (Commodity Research Bureau) Index	3.44%	9.65%
Oil (West Texas Intermediate)	11.36%	45.03%
Gold	-12.56%	8.63%

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ECONOMIC OVERVIEW

Uncertainty giving way to optimism following the election…

US: The US economy shook off the malaise of the first half with a strong third quarter, but questions surrounding the durability of the advance were widespread to start the fourth quarter. This concern was captured in the NFIB (National Federation of Independent Businesses) Uncertainty Index which hit a 42 year high to begin November, with the looming election only exacerbating the uncertainty. In the same week that the election outcome was resolved, data began coming in pointing to an economy gaining steam.

- October retail sales were reported +1%, the largest gain since April.
- December ISM manufacturing index rose to 54.7 vs. 53.7 expected. Anything above 50 indicates expansion.
- ISM non-manufacturing activity was recorded even stronger at 57.2 vs. 55.5 expected.
- November construction spending rose 0.9% from October to the highest level since April 2006.

Wage growth has consumers feeling better while businesses see better growth ahead…

These improvements helped lead to business and consumer confidence readings both increasing in the weeks following the election. The NFIB Small Business Optimism Index rose 7.4 points to 105.8 in December, a 12 year high. Stunningly, 50% of respondents to this index expected the economy to improve in the next 6 months, up from just 12% in November. Consumers were feeling even better, with consumer confidence measures reaching levels last seen in 2001. Wage growth, as measured by the Atlanta Fed, hit 3.9% in November, which helps to explain the positive outlook on the part of the consumer. Business confidence measures are important because there is an 83% correlation between that measure and GDP. Consumer confidence is clearly important because of the 70% contribution of consumer spending to GDP, although it remains to be seen how much will be saved and how much spent.

While the economy showed continued growth in the quarter, signs increased that the recovery is entering its later innings. Nowhere is this more apparent than the pace of hiring. Job growth in the quarter averaged 165,000 per month compared to 282,000 in the year ago period. Indicating a tightening labor market, this lower rate of job creation is enough to keep the unemployment rate steady but is no longer driving it lower.

Labor and housing markets flashing warning signs…

The housing sector also sent mixed signals during the quarter. Tailwinds were: rising household formations, pent-up demand, wage growth, low mortgage delinquency rates, and low inventories. Headwinds were: rising mortgage rates, high house prices, high rents, land and labor shortages, high student debt burden, and some tightening of lending standards. Housing affordability, existing home prices divided by median family income, ended the year at 17% above normal. Reflecting all of these cross-currents, 40% of young Americans were living with their parents as of 2015 (latest statistics available) – the highest since 1940.

International: In a sign of how broad-based the current global rebound is, the Leading Economic Indicators for the UK, Japan, US, Canada, Europe, Spain, Germany, Italy, France, China, Brazil, South Africa and Russia all trended up. Of the world's major economies, only the LEI in India fell - due in large part to disastrous policy decisions surrounding their currency.

Countries across the globe seeing better growth, but for how long?...

Looking forward, global indicators suggest continued improvement in growth, but there are headwinds. In the US, stricter lending standards, higher interest rates, and a stronger dollar point to tighter conditions. In China, the government continues to grapple with capital outflows and is taking increasingly stringent steps to counter them, while at the same time scaling back some of the stimulus measures recently put in place. Europe is still dealing with a refugee crisis, renewed Greek debt talks and an eventual Brexit. Perhaps most ominous of all is the fact that international trade has fallen even before implementation of any tariffs or border taxes. Through the first 9 months of 2016, US imports fell by $470 billon after falling $200 billion in 2015.

INVESTMENT IMPLICATIONS

P/Es drove the market in 2016, EPS will need to help in 2017…

The 9.5% price gain for the S&P in 2016 was almost entirely due to an expansion in the price-earnings ratio; earnings per share for the index were flat for the year. The bulk of this gain, 7.5%, occurred in the weeks following the election, when the dual tailwinds of improving economic indicators and some political certainty helped to unlock long dormant animal spirits. The expectation is that pro-growth policies traditionally favored by Republicans will help to spur on the economy and continue the nearly seven year old recovery.

With the market having achieved new all-time highs based largely on the belief that the government will move to stimulate the economy, any misstep could have an outsized effect. In the wake of the election, stocks tied to government spending jumped higher on expectations for a large infrastructure package. Banks and other highly regulated industries have outperformed, anticipating a government that will be more business friendly. Predictions for a lowering of the corporate tax rate have led to an increase in the projected earnings for companies paying near the current rate. At the same time, health care companies and those reliant on overseas operations have lagged the market as uncertainties arise regarding what kind of operating environment they will have.

Much is expected of politicians, now they must deliver…

The concern for the market is if any of these measures come up short of expectations. This is not meant as a political statement: the President-elect and many of his top advisors have never worked in public office before and may underestimate the deliberate pace in which laws are written and the compromises that may be needed to win votes. The agenda outlined is also an aggressive one, looking to overhaul the healthcare market which accounts for 18% of US GDP and rewrite the tax code to a degree that hasn't been done since Ronald Reagan.

Trade, health care, taxes and inflation all potential trip wires…

Perhaps no single issue is more divisive, or comes with more potential risk, than trade. Trade now makes up 60% of global GDP, compared to 40% as recently as the 1990's (although down from its peak as mentioned above). A disorderly shift in US trade policy, from the world's largest economy, could result in a worldwide recession.

Finally, the Fed may well be faced with an inflation shock early in the New Year. At their current levels, energy prices have doubled from their low in February of 2016. The Fed will have to decide whether this will lead to ingrained inflation, requiring a more aggressive rate hike stance, or will prove to be transitory.

With all of these potential pitfalls in mind, there is reason for optimism. While the rise in oil prices may push inflation up, it also means a healthier operating environment for energy companies which should result in higher capital spending boosting the economy. Tax reform could improve the earnings potential for US domiciled companies while the worst of the trade rhetoric may not come to pass. With confidence measures for both businesses and individuals continuing to improve, the potential for a virtuous cycle of growth unfolding, something that has not been seen during the current economic expansion, cannot be dismissed.

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